

# The CSA's March 29 proposed changes to executive compensation disclosure in Canada

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*Please note that this briefing is presented only as an initial overview of and commentary on the CSA's proposed changes; HCI will provide formal input to the CSA during the comment period.*

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## Introduction

On March 29, the Canadian Securities Administrators (CSA) released for comment a proposed set of changes to the requirements for executive and director compensation disclosure in the proxy circulars of Canadian public issuers. In developing their proposals, the CSA and its member regulators considered the disclosure rules introduced in August of 2006 by the U.S. Securities and Exchange Commission (SEC), as well as evolving best practices among Canada's largest issuers. The CSA has established a 90-day period (ending June 30, 2007) during which issuers and other interested parties have an opportunity to provide comments and suggest improvements.

### For more information:

The **Canadian Securities Administrators** is a forum for the 13 securities regulators (including the **Ontario Securities Commission**) of Canada's provinces and territories to coordinate and harmonize regulation of Canada's capital markets.

The CSA's proposed changes, commentary, and questions can be found on any of its members' websites. For example, the Ontario Securities Commission has posted the proposals at: [http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part5/rule\\_20070329\\_51-102\\_rfc-pro-repeal-f6.pdf](http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part5/rule_20070329_51-102_rfc-pro-repeal-f6.pdf)

The proposed changes follow closely the new SEC rules, although we can be thankful that the CSA has done a better job than the SEC towards developing a concise and principles-based set of proposals. The proposals represent, in our view, a generally desirable and workable evolution of Canada's corporate governance regime aimed at improving investors' understanding of how executive compensation works in the companies they own. These changes will allow shareholders and the public to better understand the link (or lack thereof) between executive pay and corporate performance, and will bring increased focus on the role of directors and how they make compensation decisions.

### Summary of changes:

- Every element of compensation to be assigned a dollar value, including
  - Stock grants (e.g. RSUs) and stock options
  - Benefits under all pension plans, including SERPs
- Compensation from all sources to be shown and totaled
  - Summary Compensation Table (SCT) will require a Total Compensation column
  - Termination scenarios (e.g. including change of control) require disclosure of all payments
- CD&A requires more description of compensation policy and decisions
  - Specific performance targets to be identified
  - Analysis of performance factors supporting compensation decisions

## Proposed changes – the major themes

There are of course many specific and detailed recommendations within the CSA's proposals, and we anticipate numerous detailed summaries to come from the legal, accounting, and consulting community. However, the overall direction of the changes is indicated in three broad areas:

- The provision of a **dollar value for every element of the issuer's compensation program**, both from ongoing plans (e.g. equity awards or changes in pension value) and from termination scenarios (e.g. change of control agreements). New tables are also included that depict the full grant date fair value of equity-based grants, and the potential payouts from non-equity grants (which for most issuers means their short-term, or annual, incentive program) under threshold, target, and maximum performance scenarios.
- The addition of a **"total compensation" column** to the Summary Compensation Table as a means of providing investors with a single number that aggregates the value of salaries, bonuses, equity awards (stock and/or options), non-equity incentive awards, pensions, and perquisites. Likewise the section devoted to exit scenarios is intended to present estimates of potential payments under different termination scenarios, including change of control, termination without cause, etc...
- The introduction of a **Compensation Discussion & Analysis (CD&A)** section. Similar in concept to the more familiar MD&A section, this is intended to ensure that each issuer describes – in plain English – how its compensation plan has been constructed, the plan's objectives and philosophy in terms of incenting certain results, and the specific targets and goals it uses to evaluate corporate performance and to set compensation appropriately. A key aim is to provide clarity about the performance sensitivity of the pay opportunities (i.e. the design of the plan) and to further discuss the actual performance assessments and compensation decisions (i.e. how actual award decisions were made). In order to stress the connection between performance and pay, the rules will require an analysis of how the trend in compensation relates to the company's trend as depicted in a total shareholder return (TSR) graph – a significant new element of minimum disclosure, not found in the U.S. rules.

The rules require consistency of disclosure in the CD&A with that contained under the existing broad Corporate Governance Disclosure requirements (Form 58-101F1). These include important themes focused on independence of decision-making, like the composition and responsibilities of the compensation committee, the identity and mandate of the committee's advisor, and the nature of any other work the advisor may perform for the issuer.

## Issues

As noted earlier, the CSA's proposals are significantly easier to digest and understand than the SEC's. However, as with any set of new ideas, the proposals raise a number of issues and points warranting some discussion. For example:

- Compensation disclosure has always been complex, and these changes will make it more so. However, given the complexity of the subject and the aim of improved transparency in disclosure, this increase in complexity would appear to be unavoidable.
- The Summary Compensation Table depicts compensation using different (and in our view questionable) accounting standards for different columns in the table. Stock options, for example, must be disclosed at the *accounting expense* value for that year (according

to Section 3870 of the CICA Handbook), which can and often does result in a number that bears no relationship to the grant date fair value of the grants actually made during the year; also problematic is the “Change in Pension Value” column which is based on the concept of change in liability rather than on the cost of the benefit earned for the year in question. In the United States these accounting definitions have already demonstrated their potential for peculiar results (e.g. Brookfield Homes reported negative total compensation for most of its top executives!). We believe that what investors really want to know is the total value of the compensation that the board granted to the executive in that year, with the accounting expense and change in present value of the actuarial liability information provided separately. Adding an “alternative” SCT to the disclosure, as some US issuers have already done (e.g. Bank of America), might be one way to ensure both objectives are met.

- The majority of annual incentives granted by companies today are linked to pre-determined performance objectives; typically called bonuses, these will now have to be categorized in the SCT as “Non-Equity Incentive Plans”, while the “Bonus” column will be reserved only for discretionary payouts that are not linked to pre-determined objectives. Since such payouts are likely to be rare, it might be wiser to eliminate the column entirely, as suggested in the CSA proposal, and to only use the Bonus column in those years when a completely discretionary payment is made.
- The proposal for a specific discussion of how the issuer’s trend in compensation relates to their TSR graph (a distinct departure from the SEC requirements), as one measure of performance, will likely cause issuers to carefully think through not only the selection of the index (or indices) but what other performance measures might be better suited for these purposes. We do not underestimate the complexity which may be involved in selecting such performance measures, and the related challenges of being able to succinctly link how an issuer’s total pay history has varied for the executive officers.

## Impacts and actions

### First steps for issuers:

- Calculate the dollar value of every compensation component (annual, and termination scenarios)
- Draft the CD&A, including the rationale for both the design and the payouts under each plan
- Identify any problems brought to light
- Revise policies and plans as required (e.g. a number of US issuers are reducing change of control plans)

For Canada’s largest issuers, we anticipate relatively few surprises and a reasonably straightforward re-ordering of existing disclosures; many of these issuers have already voluntarily moved to a standard not that far from the CSA’s proposals, and a few have already prepared drafts of their disclosures in accordance with the new SEC standards.

For many other issuers, however, these changes have the potential to be a significant challenge. These issuers will need to calculate the dollar values for every component of ongoing and contingent compensation, and it is reasonable to expect that at least some of them will be surprised by the results, which will in turn drive directors to rethink the underlying policies.

Finally, we expect that a number of issuers will want to play an active role in the CSA's 90-day comment process. For these companies, rewriting their most recent proxy to conform to the CSA proposal would be an excellent way to test drive the proposed rules. Not only will this effort generate ideas and identify unforeseen problems that will be valuable for the CSA to hear about, but it will also provide issuers the opportunity to reflect on their compensation philosophies and processes, and to ensure that they are based on best practices and are clear and understandable to investors. Next year, after all, they'll be judged on them.

We look forward to working with individual issuers and the nation's securities regulators to refine and implement this program for enhancing executive compensation disclosure in Canada.

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